Want To Close the Retirement Savings Gap?

Help employees help themselves.

By Aaron Friedman

Throughout the past year, 14 different state legislatures have taken up discussion of a retirement savings gap. In each case, the discussion has centered on creating state-run retirement savings plans covering private sector employees. Two additional state legislatures have already approved studies of this idea.

In most cases, the states would *require* employees to participate with mandated contributions through payroll deduction. The assets would accumulate in a one-size-fits-all conservative investment pool. Proponents for these sorts of programs claim they are needed due to a lack of access to retirement plan savings vehicles at work. True, there are some employers that don't offer retirement plans. Generally they are in traditionally low-wage industries where employees are more interested in health insurance or in cash to pay the rent and put food on the table. If retirement plans aren't valued by the employee demographic, there isn't a reason for the employer to offer them, and generally they don't. But employees in these industries who do want to save for retirement have plenty of options, including low-cost IRAs that are available to anyone.

The proposed mandates bring to mind an unattributed quote often associated with Friedrich Nietzsche; "Those who refuse to discipline themselves will be disciplined by others." In the case of state government mandating retirement plans for private workers, the problem is that those doing the discipline don't fully understand the magnitude of the savings need or how to meet it. There is a lack of knowledge around what it takes to help individuals achieve a reasonable level of retirement readiness and around the importance of long-term investment strategies tailored to the needs of individuals versus one-size-fits-all investment options.

While many states are looking at mandated contributions of 3 percent of payroll, analysis has shown that individuals may need to save at least 10 percent of their pay plus employer contributions over their entire working careers to reach a savings level that would replace 85 percent of their income in retirement.* However, each individual's situation is unique, and savings and post-retirement needs may differ.

Lessons from the PSCA 2014 403(b) Plan Survey

The best way to achieve these levels of contribution is to get employees to do it themselves, and the best way to get employees to do it themselves is to provide the appropriate education and incentives. So how do we get employees to save at those levels without relying on an additional level of government-forced savings (remember employees are already mandated by the government to defer earnings toward retirement via Social Security)?

Throughout the years, we've learned that personalized education and effective plan design — the kind that works *with* human behavior — can be one of the best ways to incent employees to save for their futures. The Plan Sponsor Council of America's (PSCA) 2014 403(b) Plan Survey, sponsored by the Principal Financial Group®, shows positive results from the non-profit sector when using one key incentive: employer contributions.

* Based on analysis conducted by the Principal Financial Group®, August 2013. The estimate assumes a 40-year span of accumulating savings and the following facts: retirement at age 65; a combined individual and plan sponsor contribution of 12 percent; Social Security providing 40 percent replacement of income; 7 percent annual rate of return; 2.5 percent annual inflation; and 3.5 percent annual wage growth over 40 years in the workforce. This estimate is based on a goal of replacing about 85 percent of salary. The assumed rate of return for the analysis is hypothetical and does not guarantee any future returns nor represent the return of any particular investment. Contributions do not take into account the impact of taxes on pre-tax distributions. Individual results will vary. Participants should regularly review their savings progress and post-retirement needs.

Employer Contribution Type	Average Organization Contribution	Average Employee Deferral	Total Retirement Contribution
All 403(b) plans in the survey	**4.9%**	**5.8%**	**10.7%**
Matching Contributions Only	3.9%	6.0%	9.9%
Non-Matching Contributions Only	6.5%	5.4%	11.9%
Both Matching and Non-Matching Contributions	5.2%	5.9%	11.1%

A Retirement Savings Carrot

As the chart above shows, plans with some kind of employer contribution (a match of employee deferral and/or a contribution whether the employee defers or not) when combined with employee contributions generate an average of 10.7 percent of payroll contributed annually toward retirement savings. This breaks down to an average 4.9 percent employer contribution and an average employee deferral of 5.8 percent.

The chart above further shows the impact on overall savings of various types of employer contributions.

Plans that offer matching contributions see a 6.0 percent average deferral from employees and only an average cost to the employer of 3.9 percent of annual payroll. But the overall savings result is the lowest of all the options shown with a total of 9.9 percent average annual savings rate.

Employers that provide plan only non-matching contributions — made whether or not the employee contributes — generate a total average contribution of 11.9 percent annually for retirement savings. Under this structure, employers contribute on average 6.5 percent with an average employee deferral of 5.4 percent.

Those 403(b) plans that combine both a matching and non-matching contribution end up with very reasonable overall results: good employee engagement in saving for their own retirement (5.9 percent) with significantly less expense from the employer's perspective (5.2 percent) while generating the second highest overall retirement contribution: 11.1 percent.

It is clear, though, that plan design plays a huge role in the engagement level of employees and the ability to maximize the percentage of annual income that goes toward retirement savings.

Whether it's a 10.7 percent overall average, or 11 percent or more total average annual savings rate, these are great indications that we're seeing plans starting to get up to levels for more adequate retirement savings. And the survey shows employers take advantage of the flexibility in contribution levels, so they can design plans that best align with their employee demographic and organization's bottom line.

Flexible Education

Coupling the incentives discussed above with better education for employees will help ensure that employees are actively engaged in their own retirement planning and build better financial literacy. Financial literacy is key because one-size-fits-all in investments is really a one-size-fits nobody strategy. Different people with different time horizons and different risk tolerances need choice to be able to invest according to their own time horizon and risk tolerance. They need to be educated to be able to make those choices. Technology is helping a great deal with that educational effort. The survey finds that while enrollment kits remain the most used method of education and communication (83 percent), plans have significantly increased use of e-mail over the past five years, going from 51.5 percent in 2009 to 71.8 percent in 2013. In addition, the use of webinars increased from 9.7 percent in 2009 to 26 percent in 2013.

A Primer for State Lawmakers

We all agree that we should be supporting greater savings in this country; however, state-run plan proposals generally miss the important point around savings adequacy, and ignore the need to increase financial literacy by educating working Americans. Lawmakers can look at success of the designs and educational programs unveiled in the 403(b) survey to determine what the states' best roles might be to help close savings gaps. States should be thinking about incentives to get more employers to sponsor plans with these designs, and thinking about how to encourage greater financial literacy. That will likely provide a better answer to better savings and retirement readiness with more appropriate savings.

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